Financial intermediation and the role of banking sector in the Czech Republic

Zdeněk ČECH[1]
March 2003

Abstract:

The banking sector has traditionally been an extremely important channel of financial intermediation in the Czech Republic. Despite the fact that the Czech Republic stands out among accession countries as the economy with relatively large commercial banking sector, its size remains in comparison to the EU relatively low. The paper presents major economic developments and reform steps that recently influenced the ability of credit institutions to channel financial savings into investment. In particular, it explores the currency turmoil in May 1997 and subsequent recession of Czech economy and its impact on the banks' financial position. The bad loan problem, lack of creditworthy projects and substantially increased caution of banks in granting new credits contributed to substantial slow-down (in fact deceleration) in credit growth between 1998 and 2000. The paper draws several policy implications as it focus on the following issues: institutional problems (privatisation and legal framework), privatisation of banks, presence of foreign banks in the Czech Republic, sequencing of the financial reform steps and framework of banking regulation and supervision. Presently, after the finished privatisation of large banks (to mostly EU-based banks as new owners) and extensive clean-ups of bank portfolios, the prudential indicators and efficiency of banks in the Czech Republic improved significantly. These reform steps should contribute also to the increase of credit to the private sector. The paper concludes that the Czech banks still have an enormous growth potential, especially in the area of retail banking and lending to small and medium-sized enterprises. The higher efficiency of banking sector in the allocation of resources and in the financing of investment needs should contribute significantly to speeding-up of the real convergence towards the EU income levels.

[1] I would like to express thanks to Eliška Kuchynková from HVB Bank, Czech Republic for her helpful suggestions and valuable comments during the preparation of this study.

Introduction

The Czech Republic started the transition process with a centralised, nearly completely state owned and inefficient financial sector. However, transformation of Czech banking sector has made a remarkable progress since then. Banking based on market principles – with principles of proper regulation and supervision – was established and former state-owned banking institutions were privatised. Nevertheless, the financial sector, as in all candidate countries, will have to still to go a long way before they can compare in terms of size, scope, efficiency and stability with the financial sector in present EU member states. One of the main features of candidate countries differing significantly from EU levels, though they vary considerably from country to country, is the degree of financial intermediation.

The main objective of the paper is to identify key factors influencing the role of the banking system in the financial intermediation in the Czech Republic. As the non-bank financial sector in transition countries is still nascent and does not compensate for limited bank intermediation, the banks play a key role in channelling savings into the productive investment. The selection is not, however, arbitrary as banks play a crucial role as providers of external finance in any financial system. However, their importance is underpinned by its role in the transition process. Reininger (2002) suggests that, from the broader view, the financial intermediaries play a compensating role for economic functions markets cannot fulfil. Therefore the banks are a natural focal point in the description of financial institutions.

As the banking sector in the Czech Republic is presently in the final stage of its reform, the prudential indicators and efficiency of the Czech banks improved significantly. The reform steps included extensive clean-up of portfolios and long postponed privatisation. At present, the banks in the hands of foreign strategic investors, that are hoped to enhance banks' efficiency and competitiveness, dominate to the Czech market. However, the road towards completion of banking sector reform has been often painful. In particular, the monetary turbulence in May 1997 is often perceived as a catalyst for development of the banking sector in the Czech Republic. Indeed, the change in the lending policy and connected decrease in credit growth, especially of large state-owned banks, was in years 1998 to 2000 impressive. An urgent need to re-asses the banks' strategies had redirected the credit activities towards less risky domestic securities. Of course, this must have had a structural impact on the economy, since the small and medium sized companies are dependent mostly on the domestic credit. At present, the lending to small and medium-sized enterprises, together with retail banking, is therefore perceived as the key segment for growth of the banking sector in the Czech Republic.

The paper is organised as follows: the first section focuses on the identification of position and of growth potential of the Czech Republic in terms of financial intermediation. Moreover, the link between financial intermediation and real convergence is briefly discussed on the background of simple empirical analysis of cross-country data on EU accession countries. The second section addresses the initial conditions and vulnerabilities that led in 1998-2000 to substantial decrease in credit growth in the Czech Republic, as well as outlines the key developments in the banking intermediation in the aftermath of 1997 monetary turmoil. The third section briefly touches upon the present state and outlook of banking sector in the Czech Republic. The fourth section arrives to comments on functioning of banking intermediation in the Czech Republic and draws several policy recommendations. The final section includes concluding remarks.

1. The present level of financial intermediation in the Czech Republic

1.1 Dominance of the banking in financial intermediation in the Czech republic

The financial systems in the accession countries are predominantly bank-based, whereas domestic equity and bond markets remain small. This is also the case of the Czech Republic, where the banking sector is at the core of domestic financial intermediation. In the financial sector of the Czech republic with total assets amounting to around 160% of GDP, the banks still hold dominating position with a share in total assets of about 85% (see Table 1).

Table 1: Key figures on financial institutions (2001)

	Number of institutions	Total assets (EUR bil.)	Total assets (% GDP)	Relative share in total assets (%)
Deposit money banks	38	87.0	132	85
Insurance companies	43	6.4	10	6
Investment funds[1]	136	2.5	4	2
Pension funds	14	1.7	3	2
Credit unions[2]	52	…	…	…
Leasing companies	115	4.4	7	4

Sources: Ihnat, Procházka (2002); CNB, MoF CR, CSC.

[1] Members of the Unis (Union of Investment Companies)

[2] Relative share in total assts at the end of 2001 was 0.05%.

At the outset of transition, the banks faced no competition in selling their products (i.e. providing credit) from capital markets. Moreover, the banks had a dominant position with regard to competing for savings and undeveloped capital markets played only a marginal role in the intermediation of savings into the productive investment. Though, it was not surprising as capital markets had to be created from nothing[2]. Moreover, the pension system (pay-as-you-go) in the Czech Republic has not provided incentives to population to save for retirement and the investments into pension funds became popular only lately. The redirection of funds from saving accounts – that was practically the only mean for the wider population to accumulate financial wealth in the past decade - towards other instruments in the financial market has only been gradual. Therefore, the share of banking in financial sector has been falling only slightly over the past years of transition.

1.2 Comparison of banking intermediation with the EU and other accession countries

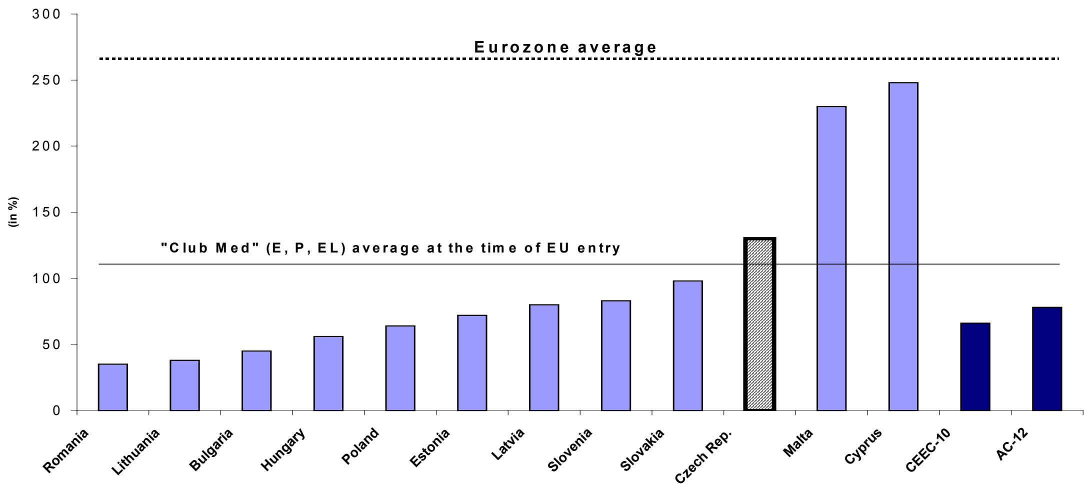
Although the banks create by far the most important pillar of financial intermediation in the EU accession countries, the degree of financial penetration through assets and loans is much lower in these countries than in the EU and also in other emerging markets. However, the Czech Republic has – in comparison with other CEEC-10 (i.e. group of the "transition" accession countries)[3] – a relatively large banking sector. The volume of the banking assets amounted in the Czech Republic to about 132% of GDP (see Chart 1).

[2] Capital markets with its short history, due to the common history of central planned economies, play an even smaller role Some authors (Desai, 1995) argue that the provision of outside funds to industry require the involvement of banks and/or government, because capital (equity) markets fail.

[3] Not including the countries with no "central planning" history: Cyprus, Malta and Turkey.

The relatively high share of the commercial banking system in the Czech Republic is partially result of historically high reliance on bank intermediation and of a large banking system already under the socialist regime. This is confirmed also by the data on Slovakia (ranking as CEEC-10 country number two with 95% share to GDP), with which the Czech republic formerly created one federation state. On the other side of the spectrum, the countries like Lithuania and Romania with banking assets of less than one fourth of the Czech Republic, mostly as result of banking crises (Reininger, 2001).

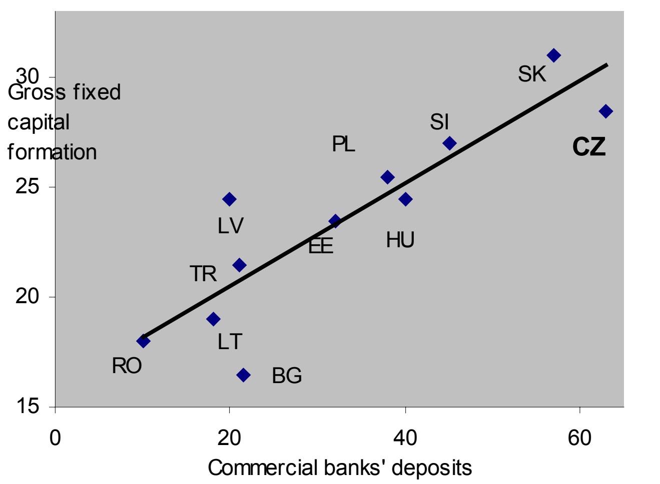
Chart 1: Size of the banking sector in accession countries (2001)
(banking assets in % of GDP)



Source: ECB (2002), IFS.

The low degree of intermediation in the EU accession countries is reflected also on the liability side. The share of deposits to GDP in the CEEC-10 is only about one-third of that in the eurozone. The Czech Republic, however, is again among the countries with highest share of 62 % of GDP (in 2002). The relatively high level of deposits in the banking system reflects the fact that the Czech Republic (in the comparison with other transition countries) did not undergo during transition the severe periods of hyperinflation, which would have eroded the real value of banks' liabilities. The Czech banking sector has been neither facing a major challenge in terms of problems with lower confidence in the system.

Chart 2: Banking and Investment (% of GDP, 2000)

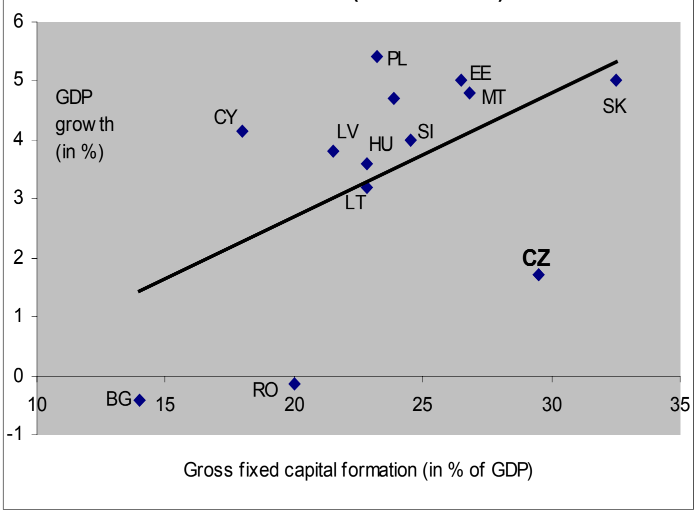


1.3 Financial intermediation and growth performance in the EU accession countries

It is certainly important to ask how the level of financial intermediation in CEECs influences the investment in the economy and consequently economic growth. As Chart 2 suggests, the size (and also by other means the costs) of financial intermediation has a direct effect on domestic investment. The candidate countries with comparatively high degree of financial intermediation (measured as commercial banks´ deposits – see Chart 2[4]), are also the countries with the highest investment propensity in the country. The data on the Czech Republic confirm this hypothesis, as this country with relatively high level of banking deposits shows also correspondingly high degree of gross capital formation.

Subsequently, one can argue that the level of investment might indirectly influence the speed of real convergence of EU candidates towards the EU levels. As it might be expected, higher investment in candidate countries tended to coincide with higher GDP growth over the period 1995 – 2000. This is suggested by Chart 3, despite the fact that the causality between those two variables might not be straightforward. Obviously, successful real convergence hinges not only upon size and efficiency of financial intermediation, but also on the stability of the financial sector as a whole, its participants and functioning of regulating institutions. The Czech Republic belongs to the group of three "outlying" countries (together with Bulgaria and Romania). Indeed, these countries experienced adjustment crises between 1995 and 2000. The Chart 4 clearly suggests that their investment rates[5] did not translate into the same investment return in the form of growth, as it was the case on the average in other "no crisis" countries. While the benefits and the need for greater investment in catching-up countries are by now largely undisputed, the chart clearly suggests that there are also challenges that need to be addressed in terms of ensuring the success of banking sector. Therefore, the factors that influenced stability and development of banking sector in the Czech Republic in 1990's and subsequently the present volume of credit to the Czech economy are in detail identified in the following chapter

Chart 3: Growth and Investment (av. 1995-2000)



2. Banking sector development in the Czech Republic in 1990s

This chapter will provide background for explaining the different behaviour of the banking system in the Czech Republic (in comparison to other economies of accession countries) and discuss the factors influencing banking intermediation and credit to private sector. For this reason, it is important to identify in brief the specific features of the transition and, in particular, of genesis of the banking sector in the Czech Republic in 1990s.

Early years of transition

The Czech Republic has undertaken a substantial effort during the last decade to build a new financial system under the constraints of the transition process from central planning to

[4] Source of Charts 3 and 4: European Commission (2001); own calculations.

[5] The Czech Republic belongs to the accession countries with highest saving ratio over the whole period of transition.

market economy. In the formerly planned regime, financial markets were non-existent: the "monobank" provided loans based on the decisions of the planning bureau and remunerating them at regulated prices. The country embarked in 1990 on the rapid liberalisation of its financial markets. It involved the creation of functioning capital market through a program of mass privatisation, along with the establishment of a universal two-tier banking system with central bank and commercial banks. The large state-owned banks were partially privatised during the first wave of voucher privatisation[6]. In this respect, the Czech Republic was in mid 1990s considered as one of the most successful examples of the post-socialist reform.

The dominance of banking sector, by far most important financial channel of the economy, was based on three factors*: stability of macroeconomic environment, almost the "non-existence" of the capital market, and the institutional framework (including the method of privatisation)*. First, at the outset of transition, the Czech authorities successfully dealt – which was not the case in all CEECs countries – with potential macroeconomic instability. The relatively stable, low inflation environment did not allow for depreciation of bank assets and the erosion of savings. As a result, the households did not have to sacrifice their savings for other types of assets in order to hedge against inflation. On the other hand, the stable macroeconomic environment and the currency devaluation in 1990-1991 did not create any incentives for needed restructuring of privatised enterprise sector and did not put sufficient pressure on the microsphere as to find alternative sources of financing. Second, an economic system with inefficient legal framework and high level of information asymmetry led to the situation in which banking sector developed faster that the capital markets. Moreover, the evidence from the first half of 1990s also shows that some of the main institutions created to oversee industrial-financial reform have been converted into the instruments of indirect, selective credit-allocation, largely due to the leverage of economically non-viable firms and their large-bank creditors (Desai, 1995). Third, the dependency of the Czech business sector on the credits also resulted from the method of privatisation chosen, where the lack of domestic capital implied that the privatisation cases were largely financed by bank loans. The method of privatisation also contributed to the fact that the capital market was squeezed by the countervailing effects of universals banking laws as the banks had powers to manage investment funds (as they were often holding a decisive share of privatising firms).

Mid 1990s – sharp credit growth

The mid 1990s can be characterised by a sharp credit growth reaching 10-15 % in real terms that was, *inter alia,* fostered by and inflow of short-term capital. The fast growth of money supply, combined with quickly growing wages and consumer spending boosted domestic demand. As the fiscal policy (in the framework of fixed exchange rate regime) was not very supportive in addressing macroeconomic imbalances, the Czech economy experienced an overheating by 1996.

A relatively high level of credit to the corporate sector in the Czech Republic in 1994 (see Table 2) reflected both the "banking tradition" and also the political willingness of state-owned banks to provide cheap credit, fearing that bankruptcies of the largest firms will send unemployment figures soaring. As a result, the dependency of the business sector on credits led in mid 1990s to situation which showed symptoms of over-borrowing and over-indebtedness (Hampl-Matoušek, 2000). The level of credit to corporate sector in the Czech

[6] However, the state kept controlling stakes in these banks (over 50% in Česká spořitelna and Československá obchodní banka, 47.4% in IPB and 44% in Komerční banka).

Republic (55.2%) was many times higher than that of neighbouring countries, with Hungary registered credits to GDP of around 19% and Poland 15.4% in 1994.

Table 2: Stock of domestic credit of the banking system
average, in % of GDP

	Czech Republic		Hungary		Poland	
	1994	2000	1994	2000	1994	2000
Credit to households	8.6	6.2	5.9	3.4	1.2	6.1
Credit to corporate sector	55.2	47.1 (55.0)	18.9	22.2	15.4	20.3
Net credit to public sector	1.0	4.7	28.8	10.1	15.7	8.4
Net credit to OFIs	0.0	0.1	0.0	1.1	0.0	1.3
Total *	64.7	58.0 (65.8)	53.6	36.8	32.3	36.0

Note: Czech Republic - data in brackets indicate the size of the credit that would have been reached if there had not been transfers of non-performing loans to state owned Consolidation Bank between 1998 and 2000.
OFIs = other financial institutions than deposit money banks.
*including FX denominated credit

Source: CNB, Reininger (2002)

However, the institutional framework led to inefficiencies, as the privatising firms largely demanded cheap credit, and old state banks were tied up in bad loans. Consequently, financial preference had been extended to some firms and restricted to others. The inflexible banking sector was not therefore capable of an effective allocation as the resources exceeded the capacity of the business sector in relation to its performance. The misallocation of available resources and under-investment in some (even profitable firms) due to various distributional struggles was the unfortunate result. However, overall still expansive lending policy of banks supported the rise in the prices of assets. The high growth rate of credits in mid 1990s backed by collateral (increasing its price considerably, mainly in the form of real estate), was not in line with the real profitability of investment projects[7]. This was reflected by high share of both classified loans and loss loans in the portfolios of Czech commercial banks.

Credit contraction in 1998-2000
The economic overheating of the Czech economy in 1996 resulted into a current account deficit of almost 8% of GDP. The restrictive monetary policy measures, however, were no efficient in addressing of persistent macroeconomic instability. In May 1997, the Czech Republic experienced monetary turmoil during which both nominal and real interest rates jumped sharply. This turmoil was a significant factor that influenced and dramatically changed patterns of banking intermediation in the Czech Republic. Following fundamental shift in lending practices between 1997 and 1999, that influenced also the credit to private sector, was largely caused by the changes in the behaviour especially of the supply side of the credit market (i.e. banks).

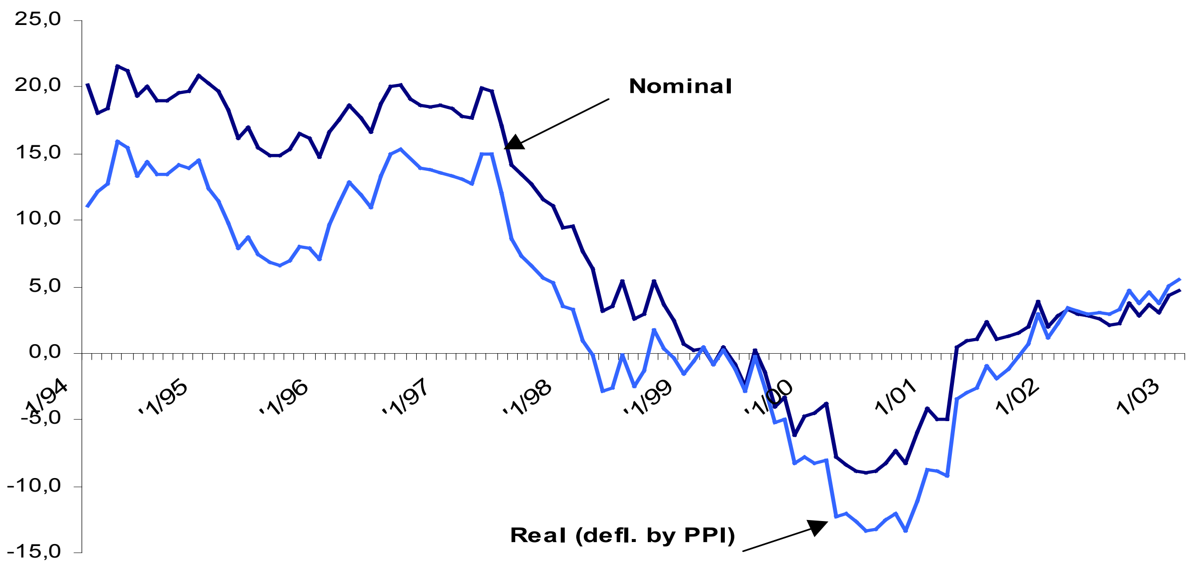
After the monetary turbulence, it was not surprising that banking sector behaviour resembled other economies (for instance Southeast Asia in the end of 1990s). However, unlike in many

[7] The Czech economy also registered over the 1990s a very high investment ratio (about 30% of GDP), but the productivity of these investments was very often low, in particular in comparison to other CEECs countries.

other emerging market crises, the main problems of the banking sector were not linked directly to exchange and interest rate risk taken by the banking sector. As the banks in the Czech Republic carried out large share of their foreign borrowing to domestic companies in foreign currency, the over-all foreign-exchange position was close to balance. At the same time, the short foreign exchange positions were hedged largely by off-balance-sheet operations. This helped significantly to reduce the scope of the crisis. The monetary turmoil in May 1997 therefore directly undermined neither solvency nor confidence in the banking sector and. Needless to say, the prudential approach of banking supervision to managing foreign exchange risk played an important role in this respect.

However, since the second half of 1997 we could monitor the year-on-year decline in growth rate of lending in the Czech Republic, that became in fact negative in real terms during 1999 and 2000 (see Chart 4). This is because the Czech banks were not completely immune to the consequences of currency turmoil, as subsequent economic recession negatively influenced the performance of domestic firms and thus exacerbated the excessive credit risk of often over-borrowed and over-indebted companies. Perhaps a more straightforward explanation of the impact of turmoil on the position of banking sector suggests that – by passing foreign borrowing to often non-hedged domestic companies – the banks just transformed the foreign exchange risk into a credit risk. As a result, the Czech banks were not influenced by the monetary turbulence directly, but rather through credit-risk channel with lag of about one to two years (Tůma, 2002).

Chart 4: Credit growth of the banking sector, Czech Republic
year-on-year change, in %



Source: Czech National Bank

The decline in lending (since approximately second half of 1997) – as argued Hampl-Matoušek (2000) – was, among other things, caused by a change in the behaviour of the group of large banks[8], especially Česká spořitelna (CS) and Komerční banka (KB). These state-owned banks experienced the sudden deviation from their former lending activity. A significant drop in the nominal volume of standard loans in the period of 1997 to 1999 (see Table 3), was connected to sudden deterioration in quality of bank's credit portfolios. This had the roots in the irrational credit allocation of the banks in question in the previous years of transition and can be explained primarily by two factors. First, the *privatisation methods* widely used bank loans, because of a lack of domestic capital, as a source of financing. These resources were not primarily used for restructuring of the companies (machinery, new technologies, etc.), but for further (sometimes very excessive) expansion in the form of mergers and acquisitions, often of the companies incapable of being restructured. Moreover, the recipients of the credits were often the entities with weak capital structure and dependent on bank loans. Second, *moral hazard of state-owned banks* was strengthened by the implicit state guarantee that provided "financial support net" for covering of any financial difficulties the banks might have. One of the reasons for this behaviour was certainly the importance of the CS and KB in the Czech banking sector, i.e. "too big too fail" argument applied in this case also.

Table 3: Real growth in lending (dissagregation of credit activity in the group of four large banks in the Czech Republic
(in %)

	1996	1997	1998
Československá obchodní banka	-4.03	18.17	13.32
Investiční a poštovní banka	7.95	-0.02	4.62
Komerční banka	3.45	**-4.13**	**-21.39**
Česká spořitelna	8.99	7.29	**-18.36**

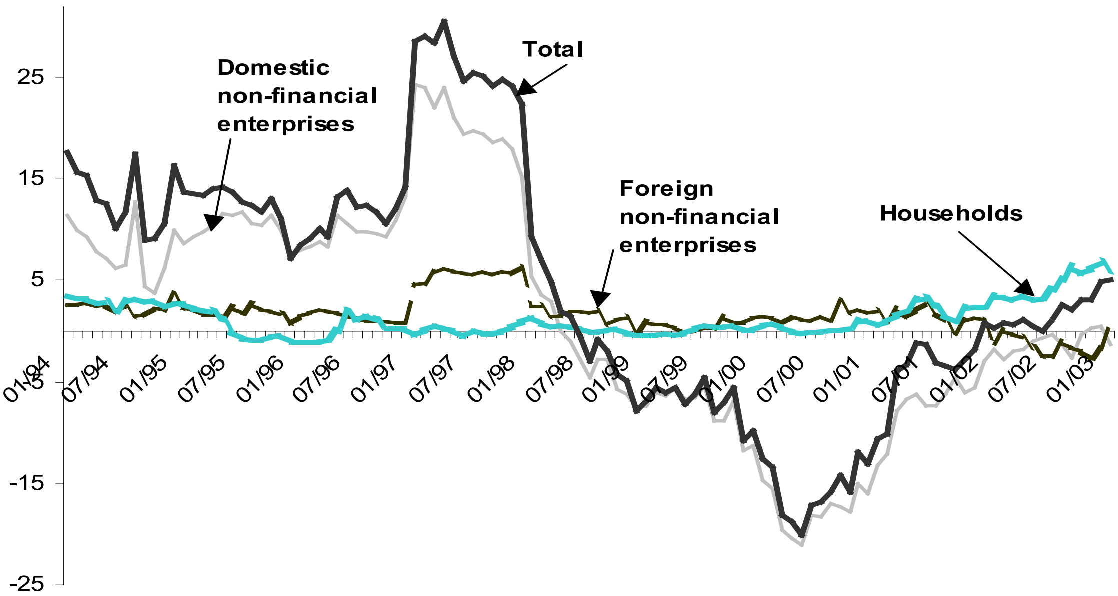
Source: Moody´s Investor Service; Hampl-Matoušek (2000)

The reasons for after-turmoil decline in credit growth in the Czech Republic were therefore closely related to the performance of the economy during first phase of transition in the first half of 1990s. The struggle for majority in companies (as it was mentioned, due to the privatisation method) contributed to the overvaluation of corporate assets. When the prices of assets begun to shift downwards in the aftermath of currency turmoil, the overvaluation of assets in the form of real estate or securities (mainly as collateral for the companies´ loans used in turn for privatisation) appeared to be of a great burden for banks. Also worsening of the quality of loans, in relation with economic decline in 1998 and 1999, combined with imposition of stricter bank regulations resulted in additional provisioning needs by banks. All these factors were connected with more prudential, i.e. significantly lower lending, and replacing credit transactions with safe trading in government securities[9].

[8] Since beginning of transition, the Czech banking sector has functioned with a high level of concentration. The three of the largest banks (CSOB, Komercni banka and CS) have over two thirds share of the market measured by the market volume.
[9] The increase in real interest rates also contributed to contraction of credit. However, this factor cannot fully explain the decline in lending in the period 1997 – 1999. After the exchange rate turbulence, interest rates shifted to a higher level than in previous period , but real interest rate gradually returned to pre-turbulence levels already in the second half of 1998.

As far as the distribution of credit by sector is concerned (see Chart 5), a decline in lending of CZK 65 billion in nominal terms was recorded in the industry from *May 1997 to September 1999*. The most substantial decline was in manufacturing of CZK 55 billion, i.e. the nominal decrease of about 20%. A substantial decline recorded also the business lending (small entrepreneurs) over the reviewed period (over CZK 20 bn.). On the other hand, the household lending experienced completely different developments as its dynamic was, especially by the end of reviewed period very high (increase by 170 percentage points in nominal terms). The increase of household lending was mainly generated by a rise in mortgages (increase by 702 percentage points over the reviewed period), by the introduction of new financial products and also by re-assessment of the strategies of commercial banks (low default risk at household sector). During this period, also willingness of households to demand credit followed an upward trajectory (in order to buy both consumer and long-term character goods). Nevertheless, an increase in household lending could only partially offset the decline in total credit (its share in total was less than 15%), with dominating influence of rapidly falling credit to industry and construction.

Chart 5: Credit growth in the Czech Republic: breakdown by sectors
(y-o-y; in %)



Source: Czech National Bank

Banking intermediation in the aftermath of currency turmoil
Despite a robust loosening of monetary policy, the response of the banking and corporate sectors was negligible. Corporate clients were, in the recession of the Czech economy, crippled by lack of creditworthy projects and with debt burden. The destructive feature of credit contraction can be explained using the example of companies that were dependent on bank credit. It is widely understandable that any sudden credit contraction to such firms must cause their unbearable financial difficulties. The attention also shifted to issue of so-called credit crunch[10], dealing with the problem of stagnation of granted loans when both nominal

[10] Hampl-Matoušek (2000), however, confirm the view that the situation in the Czech credit market during second half of 1990s did not evolve in the "credit crunch" textbook sense (i.e. situation where there is a sudden and unexpected change in the credit market without outwardly changing the relevant macroeconomic conditions on the market - interest rates, company performance etc.).

and real interest rates reached historically low levels[11]. Banks did not engaged in the extension of the credit as they were hampered by high volumes of bad loans (acquired in the preceding period of the credit expansion). Another factor influencing the development of credit was the way of managing of the large state-owned banks as they were waiting for their long postponed privatisation (ČSOB, Komerční banka and Česká spořitelna).

The increased caution of banks in granting new credits contributed to finding an alternative way to substitute for domestic credit (in the presence of still underdeveloped capital market) in the form of the inflow of foreign direct investment. This was extremely important, in particular, in terms of generating sufficient liquidity for economic recovery in the Czech Republic from year 1999 onwards. However, this was a solution of credit shortage mainly for large corporate sector companies and subsidiaries of the foreign multinationals, as they had an extensive access to financing abroad. By contrast, small and medium sized enterprises (SMEs) could not use such channel as easily and were more dependent on the domestic banking sector. Indeed, the SMEs are typically more prone to the problems of asymmetric information, often deepened by lack collateral or credit track record. Indeed, this must have had a significant structural impact on the economy, since the small and medium sized companies are dependent mostly on domestic credit.

The bad loan problem forced the government to engage in the extensive clean-ups of the state-owned banks before their privatisation to the hands of foreign owners. The costs connected with this operation amounted to CZK 33.4 bn. for Česká spořitelna (privatised by Erste Bank in 2000) and CZK 51.4 bn. for Komerční banka (sold to Societe Generale in 2001). A bailout of IPB (the minority stake was sold in 1998), that was taken under conservatorship in June 2000 and its activities resold to CSOB, are estimated to be in order of CZK 100 bn. The direct costs of banking sector reform for the state were equivalent to roughly 20% of yearly GDP.

3. Present developments in the Czech banking sector and expected trends in banking intermediation

Present developments in the Czech banking sector

Presently, the Czech banking system (as of June 2002) consists of 37 banks and foreign bank branches, down from the highest number of 55 in 1994. The largest decrease occurred, not surprisingly, in 1997 to 1999 as a result of their poor financial conditions. After the finished privatisation of large banks (mostly EU-based banks as new owners) and extensive clean-ups of bank portfolios, the prudential indicators of Czech banking sector improved significantly[12].

The striking feature of present Czech banking system is a high presence of foreign banks (see Table 4), as their market share grew sharply with continued privatisation in years 2000-2001. However, this was not the case ever since the outset of transition, as the foreign banks took primarily care of their "own clients" getting started their business in the Czech Republic. As the time passed by, they acquired the knowledge about domestic environment, monitoring

[11] The main operating rate of the Czech National Bank declined subsequently from 15% in July 1998 to the level of 5.5% during about one year (in the total number of 17 steps). The real interest rates (ex ate) ranged at that time between 0 – 3%.

[12] For instance: capital adequacy of banking sector increased from 12.10% in 1998 to 15.4% in 2001. At the same period, the ratio of non-performing loans over total loans fell from 20.4% to 13.7% and classified credits as % of total credits from 26.5% to 21.5%.

costs were reduced and, most importantly, they played an active role in privatising of large state-owned banks. At the beginning of 1990s their share was not more than 5% share in total assets of banking sector. An increased presence was marked by 20% share in 1996 and – after finished privatisation - a clear dominance achieved by foreign capital was reflected with 94.2% share in 2001. Of course, the foreign ownership of local banks does not imply increased foreign indebtedness[13], as the banks are involved in intermediating local currency. On the contrary, more stable and functional financial sector is likely to encourage more effective intermediation of domestic savings into local investment. This is a factor reducing the dependency on cross-border capital flows (for large companies and foreign subsidiaries) and – more importantly – it is opening new financing possibilities of SMEs.

Table 4: Ownership of the bank assets in the Czech Republic
(in %; end 2001)

	end 2001
Foreign capital	94.2%
State and municipalities	3.8%
Czech private holders	2.0%

Source: Czech National Bank

In 2002, there has been continued growth in the volume of client deposits, despite introduction of alternative savings products[14]. However, aggregate loans to enterprise sector (see Chart 5) have stagnated, mainly due to the fact that many banks have reduced their exposure to highly risky borrowers. At present, while banks after implementing stricter risk management measures generally face difficulties in finding good projects and lending opportunities in the corporate banking area, the retail banking sector in the Czech Republic has continued to be a rapidly growing market. All its parts, including consumer (due to the increasing willingness of Czechs to buy on credit) and housing finance (due to the historically low level of interest rates) have experienced exceptional growth-consumer finance and housing finance and further growth is expected.

Since recently, also due to the fact that foreign banks started to play a key role in enhancing the Czech banking system's performance, the profitability of the banking sector as a whole has followed an upward trend. It was mainly a result of new efficiency measures leading to a sizeable reduction in administration costs and expanding revenue sources (growing commission income and interest income on retail loans). Foreign investors in the Czech banking are also expected to exert further pressures on cost cutting as to assure high returns and to provide the continuous flow of know-how as to address widely recognised need to innovate banking products to the EU standards. Moreover, risk management's stricter discipline on borrowers and more sophisticated credit management procedures imposed by foreign owners have led to substantial decline in the volume of non-performing loans. The overall stability of the Czech banks, as reflected in the bank's capital adequacy ratios, has been improving and is continuously high as it exceeds the 8 percent benchmark by a wide margin (the indicator increased from 12.10% in 1998 to 15.4% in 2001).

In 2002, new legislative norms affecting the Czech banking market were introduced. In particular, *The Law on Banks* aimed at harmonising the legal framework in the Czech banking

[13] However, the expected outflow of profits from foreign banks is likely to influence the balance of the current account of the balance of payments.
[14] For instance mutual funds, pension funds and life assurance.

market with that of EU countries. The law covered, among other issues, the principle of a single banking license, new concepts of banking supervision, and the new scope of the deposit protection scheme (including the termination of anonymous savings accounts). In order to eliminate the lack of information on debtors, new credit registrars have been put in place - one for corporate clients and entrepreneurs, run by the Czech National Bank and one for individuals, operated by the Czech Credit Bureau. As far as the transition to new banking standards is concerned, the Czech banks will face numerous challenges arising from full harmonisation of domestic laws with EU legislation and the implementation of the new capital adequacy concept (Basle II).

All these „healthy“ trends in the Czech banking sector will undoubtedly contribute to increased efficiency in the allocation of resources, and in the longer run, to financing of catching-up process towards the income levels in the EU countries. Generally, in the run-up to the EU accession, the Czech banking sector will be affected by strong competitive pressures in the banking industry and, as the Czech Republic is small and open economy, also by global trends.

Expected trends in banking intermediation in the Czech Republic

The Czech banking sector is likely to maintain, due to the domestic tradition, the leading role in the financial intermediation in the Czech Republic. However, its *relative* importance could diminish in the longer run. The dependence of enterprises on domestic credits will likely decrease in the future, as it will be increasingly substituted by funds of the parent companies or by access to capital markets (both national and international) as a consequence of entry of foreign strategic investors into the corporate sector. Another reason supporting view on increasing presence of other means of financial intermediation than banking is the harmonisation of legal and institutional infrastructure with the EU acquis. This should increase level of the “playing-field” and to eliminate regulatory differences between particular segments of the financial sector (Ihnát, Procházka, 2002).

However, the *absolute* growth of banking and financial intermediation carried through this sector will be closely linked with the development of domestic economy. While the Czech Republic is among CEEC countries leader in banking intermediation, as measured by various indicators, the size of the banking sector is only slightly over 50 percent EU average (as measured by banking assets in % of GDP – see Section 1). The high-growth prospects of the Czech economy posses therefore enormous potential for credit growth during the convergence process. However, already highly competitive and large corporate segment offers only limited opportunities and thin margins and as well as the rapidly intensifying competition in the retail market. Most of the Czech banks have shifted their focus and “discovered” possibility of SMEs sector growth[15]. The key segments for growth of the banking sector in the Czech Republic will be therefore lending to small and medium-sized enterprises, as these segments allow for the highest potential (together with retail banking) for growth and best use of existing branch networks.

Also new trends in commercial banking are likely to influence the form of financial intermediation in the Czech Republic, and in particular, the credit growth to the private sector. Reflecting transmission of know-how within foreign owned banks and global banking developments, banks operating in the Czech market are continuing to broaden the range of

[15] Kohout (2003) suggests that we may see triple-digit growth rates in the SME market in 2003.

their products. In addition to standard retail and corporate products, local banks now offer Internet banking, home banking, GSM banking, credit cards and also private banking and wealth management services and other more sophisticated products. For example, with the aim of capitalising on numerous cross-selling opportunities, local banks have become more active in applying the integration of an insurance product into other financial service products. There have been a few examples of such products launched recently, for instance the combination of life assurance products with mortgage loans, motor insurance with leasing services and various non-life insurance policies with payment card products.

4. The Czech case: Lessons to be learned?

Comparing the factors influencing the state of the financial intermediation in the Czech Republic with the other EU acceding (transition) countries, we can arrive to a few general conclusions and policy recommendations.

Institutional problems – privatisation and legal framework
Efficient banking sector channelling resources into the productive investment will not deliver its results in terms of higher economic growth, if the challenge of ensuring the stability of banking sector is not adequately addressed. As I have shown, the problem with credit contraction in the Czech Republic that emerged after 1997 was largely a consequence of the institutional problems during transition, especially with problematic privatisation and inefficient legal framework[16]. In recent years, however, a substantial progress has been achieved in the Czech Republic in the field of legal system. An important issue for banking reform has been also a development of institutional framework that supports efficient corporate governance and strengthening of creditor rights, especially through amendments of key commercial laws.

Completion of banking sector privatisation
The state, as it was a similar case in other accession countries, generally proved to be for banks during transition a non-optimal owner, mainly due to a conflict between economic and political motivations. In the Czech Republic, the large banks (Česká spořitelna, Komerční banka) remained under state control till late 1990s[17] as the privatisation was long postponed for largely political reasons. However, also the Czech case showed that privatisation of banks – together with the clean up of their balance sheets[18] – was the only solution that could have revived the primary function of the banks, i.e. allocation of rare resources to the economy. However, it is important to note that the privatisation to the hands of foreign owners should be designed appropriately as to give the buyer sufficient incentives to restructure bank and to manage it with a aim of long-run sustainable development. The Czech state is currently involved in only two banks, which are specialised in government programs in the areas of support for small businesses and export promotion.

Presence of foreign banks

[16] There were also views that the decline after 1997 was caused exclusively by changes in the macroeconomic and monetary conditions. However, Hampl-Matoušek (2000) argue that the economic policy reacted to changed conditions in the standard way, but the reaction of the economy was way above expectations, especially due to presence of sub-optimal institutional conditions.
[17] With exception of IPB where the state lost the control over the bank already in mid 1990s
[18] Konsolidační banka (the state bank with primary function to clean-up the banks portfolios), was converted in 2001 into Česká konsolidační agentura (Czech Consolidation Agency).

The Czech experience confirms the growing presence of the foreign (largely EU-based) banks in the CEEC region. This has been of course closely linked to needed privatisation, as there has been a lack of solvent and trustworthy domestic investors in the banking sector. Moreover, the improvement of prudential indicators[19] of the banking sector soon after the entry of foreign banks into the formerly state-owned large banks suggest that financial sector reform cannot be speedily and successfully implemented in isolation from outside world. The privatisation in combination with foreign ownership offers a quicker route to improving the quality of both banks and corporate governance. The foreign involvement has brought benefits to the Czech Republic in the form of a rapid transfer of knowledge, especially in the areas of risk assessment and management. The presence of the foreign bank is therefore perceived to improve the quality, efficiency (pricing) and the availability of financial services. It should in turn foster a more efficient allocation of financial resources, which should have a positive impact on credit availability to private sector and in particular to the small and medium sized enterprises.

Sequencing of the financial reform

The Czech Republic belonged to early liberalising countries in terms of financial account of balance of payments, when the process was in fact in 1995 completed. However, the country was relatively slow in the reform of banking sector. In the Czech case, the banking sector was not in 1990s healthy shape in terms of general financial situation, credit allocation situation, corporate governance etc. This was the case of many emerging markets in 1990s too, where the weakness of the banking sector was one of the factors initiating the crisis. At the same time, the reverse causality applies: the deterioration of the state of Czech banking sector was also caused by unleashed monetary turmoil. As the capital inflows to transition and emerging economies are largely intermediated through domestic banks, the banking system should have fundamentally sound position as to achieve the best benefits of given resources. Should this condition not be fulfilled, serious problems may emerge. Therefore, the banking reform should be implemented without unnecessary delay and, in particular, the reform strategy should be synchronised with the financial account liberalisation.

Regulation and supervision

The Czech banking regulation has played an important role in stabilisation of banking sector. It significantly reduced the scope of the crisis as it has implemented stricter rules in several areas (though in shorter run it could lead to additional provisioning needs by banks and thus the measures could contribute to temporary decrease in credit growth). Since 1998 the major effort has been in harmonisation the regulatory framework[20] with the international best practices and EU acquis. The effort of CNB to incorporate the recent trends of banking supervision into the system included, for instance, a consolidated supervision of financial groups, regulation on capital adequacy of banks incorporating credit and market risks, an increasing emphasis on on-site examinations etc. Presently, the core elements of the Czech legal and regulatory framework for the banking sector in the Czech republic are already in line with what is being applied in the EU. However, the increasing integration of the Czech economy into the EU and financial flows connected to the transition period before euro introduction (for instance ERM II membership) could possibly increase the potential external

[19] For instance: capital adequacy of banking sector increased from 12.10% in 1998 to 15.4% in 2001. At the same period, the ratio of non-performing loans over total loans fell from 20.4% to 13.7% and classified credits as % of total credits from 26.5% to 21.5%.

[20] The effort of CNB to incorporate the recent trends of banking supervision into the system included, for instance, a consolidated supervision of financial groups, regulation on capital adequacy of banks incorporating credit and market risks, an increasing emphasis on on-site examinations etc.

vulnerabilities. This represents additional challenge to surveillance and monitoring capacity of national authorities as to timely recognise potential vulnerabilities. Moreover, stronger co-operation between supervisors both nationally and internationally will be forced in the future by increasing sophistication of services and a more important role of financial conglomerates.

Conclusion

The level of financial intermediation in the Czech Republic is in comparison to the EU countries still low. However, it remains, even after weak performance of banking sector in the second half of 1990s, higher than in other transition countries. The discussion on the large differences in the penetration of both banking assets and capital market securities in the economies of individual accession countries is often exaggerated, though. This paper showed that the potential benefits stemming from comparatively large banking systems will not translate into the faster catching-up process if the challenges in terms of stability of banking sector are not properly addressed. The high degree of financial intermediation affecting directly domestic investment can only have a positive effect on the process of real convergence only if the banking sector is functioning efficiently and sound macroeconomic policies are pursued.

Indeed, it was not a coincidence that the credit contraction in the Czech Republic deepened in the period following monetary turmoil in 1997 and after the change in economic policy. It was rather a standard reaction of banking sector to the change of accumulated macroeconomic and microeconomic conditions. In particular, from latter it is worth mentioning persistently unfavourable institutional environment in the Czech Republic in 1990s, especially problematic privatisation and non-standard legal framework. The policy response to such type of crisis requires system-wide policy measures, addressing both institutional issues and macroeconomic imbalance.

To sum up, the Czech experience indicates that what matters the most is the macroeconomic stability, the efficiency in allocation of resources and the quality of market institutions and of corporate governance. The reform period of the banking sector in the Czech Republic was costly both in macroeconomic and fiscal terms. However, in the last few years, decisive action has been taken to come to terms with mentioned shortcomings. After a lengthy period of restructuring, the banking sector in the Czech Republic has now been put on a firm footing and has enormous potential for the future growth, especially in retail banking and lending to small and medium-sized enterprises. As a result of these efforts, the efficiency of bank intermediation in the Czech Republic should accelerate in the years ahead.

Bibliography:

Caviglia, G.; Krause, G.; Thimann C. (2002): "Key features of the financial sectors in EU accession countries", European Central Bank, www.ecb.int. *(http://www.ecb.int/pub/pdf/financialsectorseuaccession.pdf)*

Dědek, O. (2000); "Currency Shake-up 1997: "A case study of the Czech Economy", Czech National Bank, www.cnb.cz

Desai, R.M. (1995): "Financial Market Reform in the Czech Republic, 1991 – 1994: The Revival of Repression?"; Department of Government, Harvard University, September 1995.

European Commission (2001): "Real Convergence in Candidate Countries – Past Performance and Scenarios in the Pre-Accession Economic Programmes", DG ECFIN – International Questions, Brussels, November 2001. http://europa.eu.int/ comm/ economy_finance/publications_en.htm

European Economy (11-2002): "Update of the Report on Macroeconomic and Financial Sector Stability Developments in Candidate Countries", DG ECFIN, November 2002. http://europa.eu.int/comm/economy_finance/publications_en.htm

Hájková, D.; Hanousek J.; Němeček L. (2002): "The Czech Republic's banking sector: Emerging from turbulent times"; EIB papers, Volume 7, No 1, 2002.

Hampl, M.; Matoušek, R. (2000): "Credit Contraction in the Czech Republic: Causes and Effects"; Czech National Bank, Working Paper No. 19.

Ihnát, P.; Procházka P. (2002): "The financial sector in the Czech Republic: an assessment of its current state of development and functioning" as part of contribution of the Czech National Bank into "*Key features of the financial sectors in EU accession countries", European Central Bank, www.ecb.int. (http://www.ecb.int/pub/pdf/financialsectorseuaccession.pdf)*

Kohout, P. (2002): "Shift to 'plastic money,' more help for SMEs on tap for 2003"; www.pwcglobal.com

Maystadt, P. (2002): "The financial integration of CEECs with the EU"; CEPS, Brussels, 10 June 2002.

Reininger, T.; Schardax, F.; Summer, M. (2002) "The Financial System in the Czech Republic, Hungary and Poland after the first Decade of Transition", Oesterreichische Nationalbank, Vienna.

Tůma, Z. (2002): "Financial Sector Developments in the Czech Republic"; OeNB East-West Conference paper, November 2002, Vienna, Austria. Paper also available at http://www.cnb.cz/en/pdf/tuma_vien_nov_2002.pdf.